

Date: August 15, 2018
To: Board of Retirement
From: James Wilbanks, Ph.D., Retirement Administrator
Subject: 2018 U.S. Public Pension Governance Survey Results

Attached are several documents related to this survey and the results for Mendocino County. The first document is an article from Benefits Magazine that discusses the research efforts and findings of the researchers from Marquette University and the firm Fund Governance Analytics (FGA). One of the key takeaways from the article is the significant positive correlation between measures of fund governance and investment returns.

The next document is the survey instrument that was distributed by FGA to public plans interested in completing the assessment. I completed the survey on behalf of MCERA in June 2018. As you can see, the survey is extensive. There is significant research behind the survey and the factors that go into the Fiduciary Effectiveness Quotient (FEQ).

The final document shows the 2018 results for MCERA based on my responses to the survey instrument. These results show MCERA to place in the top quintile of public plan respondents across the United States. Further, with a score of 68.98 on the FEQ, the MCERA score is well above the average FEQ score for the first quintile indicating that MCERA is likely in the top decile of respondents.

I believe this result confirms what all of us know, the Board and Staff of MCERA have done amazing work to improve the governance of the organization. We should all be extremely proud of what we have built here and we now have evidence that supports not only what we all believe, but that also shows the value of working on governance.

I am happy to answer any questions you may have.



Governance Matters: Improving Pension Plan Board Effectiveness



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Research indicates there is a strong relationship between pension plan governance and plan performance. The author identifies six key drivers of effective governance.

by | **Christopher K. Merker, Ph.D.**

As one public pension plan after another has faced financial stress in recent years, industry experts have observed that good governance can mitigate these issues and is an important determinant of long-term success. Just this past year, Willis Towers Watson asserted that “organizations with effective retirement plan governance are better equipped to manage potential retirement plan risks, protect against fiduciary liabilities and capture opportunities to improve structures, strategies and metrics.”¹

It sounds very compelling, but what does that term mean, *effective plan governance*? How do we know it when we see it and, if we don’t have it, how do we get it? How can the pursuit of good governance become a practical exercise within the reach of any organization, no matter how large or small?

The challenges for organizations when it comes to governance are to understand what comprises good governance, come up with a way of evaluating the organization’s governance and, finally, apply best practices for improvement through that process.

So, what is *governance*, exactly? A longer definition would describe the establishment and implementation of policies by a board that oversees the overall organization for the purposes of enhancing the viability and prosperity of it for a certain group of people (e.g., beneficiaries, shareholders, etc.). In the context of managing pensions or other pools of assets (e.g., foundations), governance is simply codified and structured group investor behavior that drives ongoing organizational performance.

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Research

Ask any industry observer what matters on the topic of corporate governance, and you will get a different answer each time. For example, many surveys erroneously assign importance to control of investment expense. While investment expense is a governance consideration, it turns out that the relative performance of pension plans is so highly variable that modest cost savings don’t generate significant impact on improving performance outcomes relative to peers.²

Based on corporate governance literature in our academic research, we had a general idea of what matters. But we didn’t know exactly what mattered most in the context of governing pension organizations. So we started collecting data and, in 2014, created the first-ever governance database of public pension plans. For more than two years, we collected data on 54 governance variables from dozens and dozens of public pension plans.

In addition, we collected data on what pension plans actually did, rather than what those who chose to respond to a survey said or thought they did. The list of governance variables was then further narrowed down to 17 core variables. After an in-depth examination of these core variables, we ascertained six key drivers, comprising a final index measure of governance, the Fiduciary Effectiveness Quotient™ (FEQ™).³

Findings

The research showed that governance matters. When constructing a model of corporate governance of public pension plans, it demonstrated robust statistical relationships among the governance variables and performance outcomes (i.e., investment returns, funding ratios and other financial variables).

With respect to investment returns, the pattern was clear, as shown in Figure 1.

All public pensions in the sample are sorted by the FEQ. They are then broken into quintiles, with the top quintile being the top 20% and the bottom quintile representing the bottom 20%. When five-year investment returns are overlaid, research shows that the mean investment returns for plans that scored in the top quintile of the index outperformed the bottom quintile by an average of nearly two to one, with a difference of approximately 3.5% in investment return per year. In the world of pension investing, a perfor-

mance gap that large is enormous and has all kinds of implications for future funding and viability.

Not only was the model useful in understanding impacts on investment performance but also, in the case of funding ratios, the model was 93% accurate in distinguishing winners from losers as defined by organizations that had reasonably adequate funding ratios as compared with those at highly distressed funding levels. While public pension plans were used in the research, the same concepts apply for single and multiemployer pension plans.

Specifically, from the 17 core variables, we identified six main drivers of effective governance.

1. Professionalism

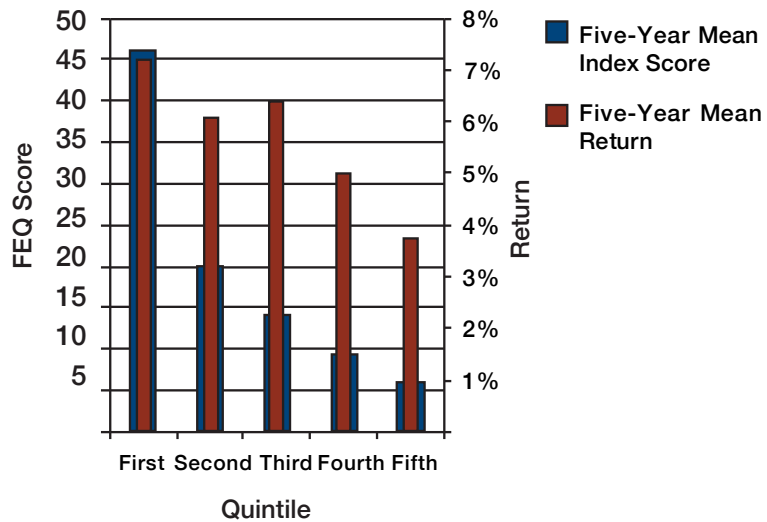
This driver is a measure of the level of professionalism within the organization. Examples of factors that comprise it are: To what extent is the consultant involved in guiding and informing the process? How often does the board meet and for how long? To what extent is the board documenting and disclosing its activities and decisions? How much board representation do the investment and audit committees have? What are the substantive matters being discussed at the board level?

2. Board Composition

What is the mix of the board? Whose interests are most represented: those of the sponsor (e.g., company or municipal government), those of the beneficiaries (e.g., union members) or those with more independent points of view? What are the backgrounds of the individuals? Do they have the proper training and experience for what they are charged with overseeing?

FIGURE 1

Public Pension Fund Performance by Fiduciary Effectiveness Quotient (FEQ) Quintile



3. Engagement

Another important driver is the degree of engagement by the board members, staff and consultant. Is everyone participating and engaged in the process? How much turnover is happening at the leadership level? At the consultant level? Strong leadership is critical to keeping the other board members engaged in

the governance process. Also, do the individuals on the board have time for engagement, or are they busy with multiple demands and unable to devote enough time to the issues at hand?

4. Staff

Is there sufficient staff or employee representation? Having professional

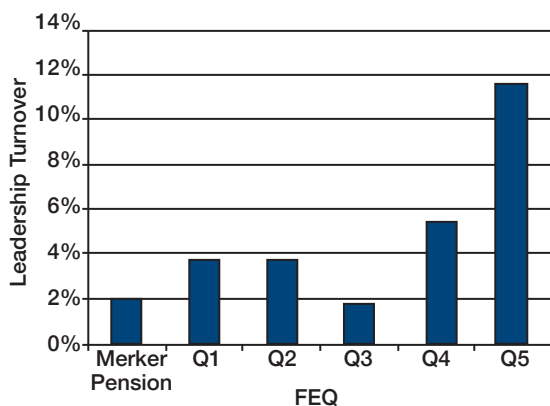
takeaways

- A governance database of public pension plans developed by researchers collected data on 54 governance variables to measure the impact of governance on plan performance.
- Researchers found a strong relationship between governance variables and performance outcomes such as investment returns, funding ratios and other financial variables.
- Researchers identified six key drivers of effective governance: professionalism, board composition, engagement, staff, institutional knowledge and diligence.
- Boards of public, corporate and multiemployer pension plans can conduct a baseline evaluation of these drivers and follow up with a more detailed self-assessment using available tools.
- Governance assessment should be a standing item for annual review to help plans identify areas for training and development, track improvement and set future goals.

FIGURE 2

Fiduciary Effectiveness Quotient (FEQ) Factors—Leadership Turnover by Quintile

Strong and consistent leadership is important for top organizations and is a key factor in institutional knowledge and continuity of the organization. Higher performing groups demonstrate lower turnover rates among the board chairperson, on average no more than once every two years.



staff serving on the board, or at least attending the meetings, is important because it allows people closest to the operation to inform the board of ongoing activity and remain connected to oversight and decision making.

5. Institutional Knowledge

This driver represents the continuity within the organization itself. How much professional experience do board members have? To what extent are board members and the consultant turning over each year? High rates of turnover can erode knowledge and continuity. Too little turnover can indicate a lack of fresh ideas coming into the process.

6. Diligence

The final driver is defined by the extent of diligence and thoroughness of the organization in exercising its governance process and making decisions. Underlying factors include consultant participation, extent of meeting documentation, involvement and direction by staff, and key discussion points.

Other Factors

As part of best practices, other aspects should be considered in addition to these drivers, including use of investment

policies, board diversity, compensation and management of conflicts of interests, among others. Once a board goes through a baseline evaluation, it then can engage with board members and senior staff in a deeper self-assessment that reviews additional topics that, using board self-assessment tools such as the Governance Self-Assessment Checklist (GSAC) module, can include further analysis of board structure, board and organizational culture, board responsibilities and board process.⁴ Making board governance assessment a standing item for annual review helps the organization identify areas for training and development, tracks improvements over time and allows the setting of new goals for the coming year.

Putting Knowledge Into Practice

The next step is to apply this research in a way that can be useful for organizations. This can be accomplished with two steps. The organization (1) finds a way to efficiently and accurately collect information to help it evaluate its practices and (2) compares results with its peers. There are a number of board assessment instruments in the market to help the board undertake a self-assessment. However, peer benchmarking is more difficult to find.

One example of the assessment reporting shown in Figure 2 is leadership turnover of the board, or the rate at which leadership changes within the organization. As noted, at

bio




Christopher K. Merker, Ph.D., CFA,

is executive director of Fund Governance Analytics, LLC, a provider of governance research and diagnostic tools for asset

owners and institutional investors. Merker holds a Ph.D. degree in investment governance and fiduciary effectiveness from Marquette University. He is a past president and a current board member of the CFA Society Milwaukee and is an adjunct professor of finance at Marquette University, where he teaches the investment course Sustainable Finance. He also publishes the blog *Sustainable Finance*, which covers current topics around governance and sustainability in investing (www.sustainablefinanceblog.org).

higher levels this can impact overall continuity and engagement. In this hypothetical example, the board of Merker Pension learns how turnover in the chair position can impact organizational performance and how the organization stacks up against its peers. Lower levels of turnover is a feature of upper quintile organizations, with the highest level of turnover found in the bottom quintile.

Conclusion

In closing, consider the words of researchers Gordon L. Clark and Roger Urwin, who have written extensively on the topic of governance over the years: “Good governance by institutional fund asset owners (pensions) makes a significant incremental difference to value creation as measured by their long-term risk-adjusted rate of return . . . [F]unds can create more value if they correctly assess their governance and determine an investment strategy commensurate with their capabilities.”⁵ 

Endnotes

1. See www.willistowerswatson.com/en/insights/2016/05/strategies-in-retirement-plan-governance.
2. See “Investment Expense a Proxy for Good Governance,” by Christopher K. Merker, CFA Enterprising Investor, October 9, 2017, <https://blogs.cfainstitute.org/investor/2017/10/09/investment-expense-as-a-proxy-for-good-governance/>.
3. Christopher K. Merker, *Asset Owner Governance and Fiduciary Effectiveness: The Case of Public Pension Funds*, Marquette University, ©2017. The FEQ is a trademark of FGA-Diagnostics, LLC, patent pending, http://epublications.marquette.edu/dissertations_mu/713/.
4. Copyright ©2000 Mel Gill. All Rights Reserved. Used by FGA-Diagnostics, LLC, with permission.
5. Gordon L. Clark and Roger Urwin, *Best-Practice Investment Management: Lessons for Asset Owners from the Oxford–Watson Wyatt Project on Governance*, Oxford University, 2007.





FEQ™ Questionnaire

- 1 Identify the type of organization for the assessment.
- 2 What is your role in the organization?
- 3 How often do you conduct governance self-assessments?
- 4 What is your fiscal year?
- 5 What were the investment returns for the each of the last five years?

If your organization oversees a pension plan, what has been the funding
6 ratio for each of the last five years?

If your organization oversees a pension plan, what is the actuarial rate of
7 return in use?
- 8 What is your current asset allocation?
- 9 What was the current market value of your assets as of your last valuation?
- 10 Who is your investment consultant (list additional if needed)?
- 11 If applicable, who is your actuary (list additional if needed)?
- 12 On average how often do you change your primary consultant?
- 13 How often does your board meet?
- 14 On average, how long does your board meet at each meeting?
- 15 How big is your board (number of members)?
- 16 What is the average annual percentage attendance of your board?

- 17 What is the average annual attendance of your primary consultant?
- 18 How many new board members have come on in the last year?
- 19 How many board members serve on the investment committee?
- 20 How many board members serve on the audit committee?
What percentage of the board is appointed (by the governor or some other executive authority)?
- 21
- 22 What percentage of the board is elected (by a union or some other body)?
- 23 What percentage of the board is professional staff?
On average, what percentage of board meeting attendees is comprised of staff?
- 24
- 25 How long has the current board chair served in their role?
What percentage of your board is comprised of members who are retired from their primary occupation?
- 26
- 27 Please upload copies of the last year of meeting minutes.
- 28 Do you have an investment policy statement (IPS)?
If you answered yes in question 28, how often does your board review your IPS?
- 29
- 30 What is the percentage of women on your board?
- 31 What is the percentage of minorities on your board?
- 32 Not including paid staff, is your board compensated?
What percentage of the board has a background in investments, accounting or actuarial science?
- 33
- 34 How would you characterize the level of professional experience of your board?

35 What is your total annual investment expense as a percentage (basis points) of total assets?

36 How often does your organization conduct board training?

GSAC QuickCheck Questionnaire

- 1) This organization's orientation for board members adequately prepares them to fulfill their governance responsibilities.
- 2) This board is actively involved in planning the direction and priorities of the organization.
- 3) The board does a good job of evaluating the performance of the Executive Leadership (CEO/CFO/CIO/Treasurer/Executive Director)
- 4) This organization is financially sound (viable and stable).
- 5) Board members demonstrate a clear understanding of the respective roles of board and executive leadership (CEO/CFO/CIO/Treasurer/Executive Director).
- 6) The organization's resources are used efficiently (good value for money spent).
- 7) The board has high credibility with key stakeholders (e.g. funders, donors, beneficiaries, investors, taxpayers, etc.).
- 8) Board members demonstrate commitment to this organization's mission and values.
- 9) Board members comply with requirements outlined in key elements of the governance structure (bylaws, policies, code of conduct, conflict of interest, traditional/cultural norms, etc.).
- 10) The board's capacity to govern effectively is not impaired by conflicts between board members.
- 11) There is a productive working relationship between the board and executive leadership (characterized by good communication and mutual respect).

- 12) I am confident that this board would effectively manage any organizational crisis that could be reasonably anticipated.
- 13) Board meetings are well-managed.
- 14) The board uses sound decision-making processes (focused on board responsibilities, factual information, efficient use of time, items not frequently revisited, effective implementation).
- 15) This organization has a good balance between organizational stability and innovation.



Module 1 - FEQ Comprehensive Report

2018 - U.S. Governance Survey

Mendocino County Employees Retirement Association

Peer Group: Public Pension Funds

Date: June 4, 2018

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FEQ Comprehensive Report 2018 - U.S. Governance Survey



About the FEQ

Empirical studies have shown that the effectiveness of any board is driven by many structural and process elements including its independence, composition, size, committee structure, turnover and levels of engagement. The Fiduciary Effectiveness Quotient (FEQ)[™] was developed on the basis of thirty years of corporate governance research and applied to the investment management arena. Asset Owners (pension funds, endowments, foundations and other dedicated funds) are subject to many of the same board organizational and stakeholder issues.

Based on a five-year study conducted at Marquette University, culminating in a unique comprehensive database on public pension funds, the FEQ was constructed from a thorough analysis of governance variables. Our examination of the original 51 variables collected, was reduced to 17 of the most relevant factors. Through an econometric method known as Principal Components Analysis, we further condensed these variables into six components: 1) Professionalism; 2) Board Composition; 3) Engagement; 4) Staff; 5) Institutional Knowledge; and 6) Diligence. These components represent the six subscales of organizational governance, and each varies in their impact and respective importance in driving outcomes.

When analyzed in relation to key financial performance metrics, we found strong evidence of a causal relationship between these governance factors and financial outcomes in the following year. The best scoring organizations saw investment returns that were consistently higher than other organizations; and for each unit increase in the FEQ we saw a commensurate increase in returns. **The FEQ is a unique measure that can inform asset owners how well their boards are fulfilling their fiduciary duty.**

The FEQ allows us to assign a governance rating to any organization from data collected within approximately 30 minutes from an informed respondent, typically a Chief Investment Officer or other business leader within the organization. The data is further added to- and validated - by meeting minutes uploaded to our data collection system. Once the organization is scored, each governance factor is further examined on a quintile basis (e.g., first quintile is strongest, fifth quintile is weakest), showing where the subject organization falls in relation to its respective peer group. Areas for improvement emerge based on the organizations standing relative to its peers.

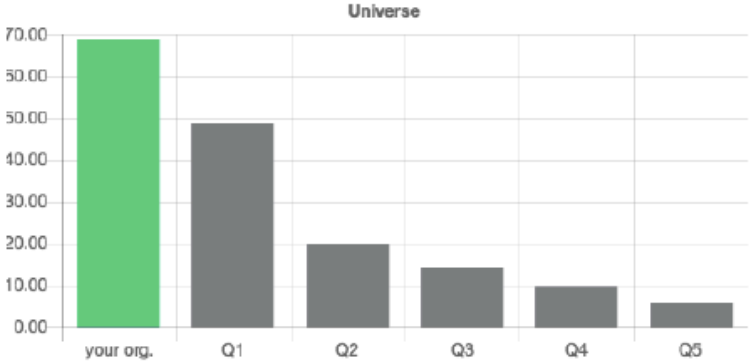
For your organization, the following pages provide comparative analysis across each FEQ factor, and will highlight each area for strengths and weaknesses across the organization. The organization is benchmarked to the respective peer group and the overall universe for each factor. We have also included other governance topics as part of a further examination of best practices of fund management organizations.



FEQ Comprehensive Report 2018 - U.S. Governance Survey

FEQ by Peer Group and Universe by Quintile

There are significant differences in the FEQ that separate Quintile 1 from the other quintiles.



Your organization’s FEQ score is 68.98. This places you in the first quintile among the U.S. Public Pension peer group.